SfC ASSOCIATES
Securities and Financial Consulting

The Libor Scandal and Its Effects Explained

As if the credit crisis and rogue traders were not enough to undermine the reputation of the financial services industry, along comes an issue that may dwarf them: the rigging of the London Interbank Offered Rate, or Libor, by a number of global banks. Libor is arguably the most widely-used interest rate in the world. Manipulating this rate by even small percentages can result in extremely wide-ranging consequences.

Many banks need to borrow cash on a daily basis to strengthen their balance sheets while other banks with excess cash wish to earn interest by lending out money. Thomson Reuters, on behalf of the British Bankers' Association, asks a panel of about twenty banks, "[a]t what rate could you borrow funds, were you to do so by asking for and then accepting inter-bank offers in a reasonable market size just prior to 11 am?"[1] The highest and lowest four rates are discarded from the average calculations. An average of the remaining rates results in Libor. There are exactly 150 distinct Libor rates, covering 15 different borrowing periods ranging from as short as overnight to as long as a year and spanning 10 different currencies.

Libor is important for a number of reasons. Nearly every rate used in financial calculations has its basis in the Capital Allocation Pricing Model. The model essentially states that whatever interest rate required for any risky venture will necessitate a compensation rate above a "risk-free rate." In other words, the riskier a security, portfolio, or an investment in general, the higher the spread above risk-free rate an investor will demand. Most governments, banks, and investors believe Libor to be an appropriate measure of the risk-free rate, resulting in the use of Libor to calculate a range of other rates, from mortgages to car loans. It is estimated that Libor is tied to

[1] http://www.bbalibor.com/bbalibor-explained/the-basics

financial products whose values total to around $800 trillion.[2] In addition to being a benchmark for calculating other rates, Libor is also used as a gauge for the overall health of the banking industry. When a bank is charged a higher rate, other banks believe it to be riskier. Such an event occurred during the recent 2008 financial crisis, when Libor rates were at abnormally high levels. However, the Libor rates did not remain high, and in fact fell to pre-crisis levels within a few months. Cracks within the Libor system were beginning to show.

Historically, the Libor rate has been difficult to manipulate, as deviations from the norm would be apparent. Yet many problems with the Libor calculation process existed and were known for quite some time. Libor has always been based on a self-reporting system. Rate submitters within each bank on the Libor panel would submit the rate they were being charged to borrow capital. Due to little to no regulation, banks could submit rates that benefited them the most.

Barclays has been suspected of manipulating rates lower in an effort to bolster an image that the bank was financially stable in a time of economic crisis. In addition, according to evidence gathered by regulators, Barclays manipulated the Libor rate they submitted to Reuters in an effort to benefit their own trading positions. Allegedly, fourteen traders within the firm violated the Chinese wall – an informational divide within a bank that separates those with undisclosed knowledge from those who make investment decisions, thus deterring conflict of interest issues – by contacting their bank's rate setters and allegedly asking them to submit a total of 257 false rates.[3]

When the Libor rate is manipulated downwards, the prices of bonds on the banks' balance sheet rise. In addition, any loans on the balance sheet whose interest rates are tied to Libor will now

---

[2] http://www.forbes.com/sites/halahtouryalai/2012/07/12/libor-lawsuits-are-piling-up-and-could-cost-billions-banks-brace-for-another-big-legal-battle/

[3] http://www.ft.com/intl/cms/s/0/dd46517e-c072-11e1-9372-00144feabdc0.html#axzz2J0NXsrOj

be repaid in the future at a lower rate. Internal emails uncovered from a Barclays trader revealed that even a basis point (.01%) drop in the Libor rate could create a few million dollars in gains for his positions.[4] Other banks with similar balance sheet would also benefit. In addition, any borrower, whether it is a student getting a loan for college or a family getting a mortgage to buy a house, would also benefit from a lower Libor rate.

Nearly all financial transactions involve a zero-sum game; when one party reaps a gain, another party must suffer a loss of equal magnitude. When Libor rates were manipulated downwards, lenders of cash received a lower interest rate than they should have. These lenders could include any person with a savings account, an institutional lender, or large pension funds and municipalities, all of whom lost millions. The scope of this Libor rigging scandal is larger than any previous financial scandal in history, even larger than the Madoff Ponzi Scheme and the Enron Scandal. Essentially any person or company lending or borrowing money is affected. Those investing in equities are also indirectly affected, as the spread between their returns and the risk-free rate is reduced if Libor is rigged upwards, leading to a lower absolute return.

Even without government intervention, Libor failed to be a perfectly competitive rate. Many are asking how one bank could single-handily manipulate Libor to benefit its own balance sheet. The short answer is that one bank most likely cannot. It is alleged that other banks were involved as well. Instead of being a perfectly competitive rate, Libor became an oligopolistic or cartel-like rate, benefiting only those involved in the rigging process. In addition to Barclays (which settled for $450 million), other banks such as the Union Bank of Switzerland are also being investigated by the FSA

[4] http://www.businessinsider.com/how-barclays-made-money-on-libor-manipulation-2012-7

for wrongdoing.[5] UBS announced a settlement for $1.5 billion, in addition to a Japanese unit pleading guilty to criminal fraud charges.[6] Over a six year time frame, internal emails revealed widespread coordination by members within the firm to manipulate Libor. Some traders openly boasted about their profits as a result of rigging Libor. "According to regulators, dozens of UBS employees, seeking to bolster their trading profits and to improve outside perceptions of the bank's health, tried at least 2,000 times to manipulate a variety of benchmark interest rates, often with the knowledge or even encouragement of senior managers at the bank. The FSA called the efforts "routine and widespread.""[7]American regulators are also investigating large banks including J.P. Morgan Chase, Bank of America, and Citibank in addition to a number of other banks.

Lawsuits are already starting to accumulate in the courts from a diverse array of investors. One of the first individuals to file a lawsuit concerning the rigging of Libor, private investor Richard Hershey alleges that a group of banks violated the Commodity Exchange Act by manipulating Libor for their own reputational gain.[8] "They were loath to disclose the true risk premium that the market was attaching them during the financial crisis," he said. As a result of these actions, Mr. Hershey claims that he received a lower rate of return for Eurodollar futures he purchased on the Chicago Mercantile Exchange. Similarly, Green Pond Road Associates, a limited liability corporation, is suing a group of banks for their ties to the Libor scandal.[9] Green Pond alleges that by manipulating Libor, banks violated both the Sherman and Clayton Antitrust Acts, which prohibit certain practices intended to impede free market competition.

---

[5] http://www.wsws.org/en/articles/2012/12/20/libo-d20.html
[6] http://online.wsj.com/article/SB10001424127887324407504578188342618724274.html
[7] http://online.wsj.com/article/SB10001424127887324407504578188342618724274.html
[8] Richard Hershey v. Credit Suisse Group AG, et al. Illinois Northern District Court. Case No. 11-cv-02625.
[9] 33-35 Green Pond Road Associates, LLC v. Bank of America Corporation, et al. New York Southern District Court. Case No. 12-cv-5822.

Recently, a group of homeowners based in Alabama have filed a putative antitrust class action against a number of banks, including Bank of America, JP Morgan Chase, and Citigroup.[10] The homeowners allege banks intentionally raised Libor on the first day of each month, resulting in Libor-based adjustable rate mortgages costing two basis points higher than average. Cities and municipalities that suffered losses are seeking payment in the courts as well. For example, the city of Baltimore purchased tens of millions of dollars' worth of Interest Rate Swaps from banks such as Bank of America and J.P. Morgan Chase.[11] Since these securities were indexed to Libor, the city of Baltimore allegedly received far less money than it was owed.

A variety of banks both large and small are also suing the banks involved in the Libor rigging process. As mentioned previously, the Libor rate is established by the banks involved in the submission panel. Many banks left out of the process claim to have been harmed by Libor rigging just like any other investor. For example, Charles Schwab Bank[12,13] and Berkshire Bank[14] claim they received a lower rate of return on Libor-tied securities than owed.

As early as 2007-2008, American regulators detailed possible flaws and manipulation in the Libor submission process. In 2008, Timothy Geithner, the President of the Federal Reserve Bank of New York at the time, revealed the result of a Libor investigation to the President's Working Group on Financial Markets, the U.S Treasury Department, and the Bank of England.[15] These findings later led the U.S Federal Reserve Chairman Ben Bernanke to state that Libor was

---

[10] Adams et al. v. Bank of America Corporation, et al. New York Southern District Court. Case No. 12-cv-07461.
[11] Mayor and City Council of Baltimore v. Bank of America Corporation; Barclays Bank PLC, et al. New York Southern District Court. Case No. 11-cv-05450.
[12] Charles Schwab Bank, N.A., et al. v. Bank of America Corporation, et al. California Northern District Court. Case No. 11-cv-4187.
[13] Schwab Money Market Fund, et al. v. Bank of America Corporation, et al. California Northern District Court. Case No. 11-cv-4186.
[14] The Berkshire Bank v. Bank of America Corporation, et al. New York Southern District Court. Case No. 12-cv-5723.
[15] http://www.newyorkfed.org/newsevents/news/markets/2012/Barclays_LIBOR_Matter.html

"structurally flawed" during a hearing before the Senate Banking Committee.[16] Since the Libor scandal began, a number of academics, including Kermit Schoenholtz (NYU Stern/Director of the Center for Global Economy and Business) and David Evans (University of Chicago/Chairman of the Global Economics Group), have also weighed in with their thoughts on the flaws within the Libor system and how manipulation could have occurred.

Yet despite the abundance of publically available evidence, the bulk of evidentiary support lies within the hands of the banks involved in the scandal. Once available through discovery, expect the floodgates to open on lawsuits filed. Total damages could eventually reach billions of dollars.

[16] http://money.cnn.com/2012/07/17/investing/bernanke-libor/index.htm